22 June 2023
Agenda Paper 9

Provisions – Targeted Improvements

Executive Summary

Project Type	Influencing
Project Scope	Moderate

Purpose of the paper

The purpose of this paper is to:

- summarise the challenges identified by the IASB staff with regard to the present obligation recognition criterion in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets;*
- outline the IASB staff proposals to resolve those challenges; and
- describe the scenarios when the proposals may lead to changes in accounting outcomes.

In addition, the paper sets out the questions on this topic expected to be asked of ASAF members at the July 2023 ASAF meeting.

Summary of the Issue

The IASB has begun to develop proposals to make targeted improvements to IAS 37. Initial IASB staff proposals include updating the definition of liability and amending the requirements and guidance supporting the recognition criteria, using the Conceptual Framework as a guide. The intention of these proposed amendments is to make the requirements easier to apply. They would also lead to a change in the timing of recognition in some instances.

This paper covers the following principal topics:

- Why the IASB is considering amendments.
- Staff suggestions for improvements
- Questions to be asked by the IASB at ASAF

Decisions for the Board
The Board is not requested to make any decisions on this topic at this meeting. However, the Board is asked for comments on the following questions: ***Overall reactions*** • What are the Board's overall reactions to the possible amendments? • Do Board members have any comments on any specific aspects of the possible amendments? ***Thresholds*** • Do Board members consider that IAS 37 should specify when an entity has a present obligation for costs payable if a measure of its activity exceeds a specified threshold? • Do Board members have views on when the present obligation arises? ***'No practical ability to avoid'*** • Do Board members consider that IAS 37 should include guidance on the meaning of 'no practical ability to avoid'? • Should IAS 37 retain the requirement that settlement of a legal obligation 'can be enforced by law'? • What, if any, role do Board members consider that economic compulsion should play in assessing an entity's practical ability to avoid an obligation?
Recommendation
N/A
Appendices
None

UK Endorsement Board

Background

Scope of the IASB project

1. In this project, the IASB is developing proposals to make improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in three main areas:

   a) to update the liability definition and amend the requirements and guidance supporting the recognition criteria, applying concepts added to the Conceptual Framework for Financial Reporting in 2018;

   b) to specify more precisely the rate an entity uses to discount a long-term provision to its present value; and

   c) to specify which costs an entity includes in measuring an obligation to provide goods or services.

2. At its April 2023 meeting, the IASB discussed possible amendments relating to the first of those areas.

3. The amendments would be to:

   a) the definition of a liability;

   b) the wording of the recognition criterion applying that definition—the requirement for an entity to have a present obligation as a result of a past event (the present obligation recognition criterion); and

   c) the requirements and guidance supporting that recognition criterion.

4. The overall aim of the amendments would be to clarify the requirements, making them easier to apply and reducing the risk of inconsistent application, and to change the timing of recognition in some cases.

Analysis of Key Issues

Why the IASB is considering amendments

Current requirements in IAS 37

5. A provision is defined in IAS 37 paragraph 10 as “a liability of uncertain timing or amount”.

6. IAS 37 paragraph 10 defines a liability as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits”.

7. IAS 37 paragraph 14 requires a provision to “be recognised when:

    a) an entity has a present obligation (legal or constructive) as a result of a past event;

    b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

    c) a reliable estimate can be made of the amount of the obligation.”

8. The proposed amendments would affect only the present obligation recognition criterion (that is, (a) in paragraph 7 above). They would not affect the other two recognition criteria in IAS 37—the ‘probable outflows’ and ‘reliable measurement’ criteria.

Challenges with IAS 37

9. The IASB staff are proposing amendments to the requirements and examples accompanying IAS 37 due to the challenges that have arisen while applying them.

10. The specific application challenges identified by the IASB staff include:

    a) difficulties in disentangling the elements within the present obligation criterion;

    b) dissatisfaction with IFRIC 21 Levies, which interprets the present obligation criterion; and

    c) questions arising in applying IAS 37 to climate-related regulations and commitments.

Entanglement of the elements within the present obligation criterion

11. In the view of the IASB staff, the IAS 37 definition of liability is problematic because although it identifies two distinct elements - (i) a past event must have created a present obligation and (ii) there must be no reasonable alternative to settling that obligation - it does not describe them individually. Instead, it incorporates both principles in the definition of an obligating event (paragraphs 17-22 of IAS 37).

12. The staff consider that the distinction is unclear between:

    a) actions that *give rise to* an obligation – which must have occurred in the past (a question of timing); and

    b) actions that *settle* an obligation – which will have to be taken in the future because there is no reasonable alternative to settling that obligation (a question of enforceability).

13. This lack of clarity leads to difficulty in applying IAS 37 in instances when a past event could lead to an outflow of economic resources, but the entity could prevent that outflow by its future actions. Does an entity have a present obligation that it should recognise if those future actions are not realistic? Or does it not have a present obligation at all?

Dissatisfaction with IFRIC 21 Levies, which interprets the present obligation criterion

14. The IFRS Interpretations Committee, in response to requests for more guidance for specific fact patterns, concluded that an entity does not have a present obligation until it takes the action to which a charge is linked. This applies even in instances where there is no reasonable alternative available.

15. However, stakeholders have raised questions around the following:

    a) Apparent inconsistency between the principle that applies to levies and that applied to restructuring costs.

    b) The fact that application of IFRIC 21 results in some recurring periodic levies being recognised as expenses at a single point in time. Stakeholders believe that the economic substance of a recurring levy would be more faithfully represented by recognising the expense gradually over the period to which it relates.

    c) The application of IFRIC 21 is not consistent with requirements in other IFRS Accounting Standards, for example IFRS 2 *Share-based Payments,* that address other obligations that rely on more than one action of the entity.

Application to climate-related regulations and commitments

16. The IASB staff have identified additional challenges with the application of the present obligation recognition criterion in relation to climate-related regulations and commitments. This is particularly apparent in instances when:

    a) responsibilities imposed by climate-related laws and regulations are not enforceable in conventional ways—they are structured so an entity is not compelled to comply but nevertheless may have a strong economic incentive to do so; or

    b) an entity makes a public commitment to change its method of operation—for example to reduce greenhouse gas emissions to 'net zero'—in the future.

17. The IFRS Interpretations Committee considered some of those challenges in relation to a government's measures to encourage vehicle producers to produce low emission vehicles. In that fact pattern, the government had no right to compel producers to comply with the measures but had a right to impose economic

sanctions on those that failed to comply—for example, restricting their market access in the future.

18. The Committee reached conclusions on how to apply IAS 37 to those measures, publishing those conclusions in Agenda Decision Negative Low Emission Vehicle Credits in July 2022.

19. The Committee concluded that the measures described in the request could give rise to a legal obligation:

    a) obligations that arise under the measures derive from an operation of law; and

    b) the sanctions the government can impose under the measures would be the mechanism by which settlement may be enforceable by law.

20. The Committee further concluded that an entity would have a legal obligation that is enforceable by law if accepting the possible sanctions for non-settlement is not a realistic alternative for that entity. They further noted that determining whether accepting sanctions is a realistic alternative for an entity requires judgement and that the conclusion will depend on the nature of the sanctions and the entity's specific circumstances.

Staff suggestions for improvements

21. The IASB staff have grouped their suggestions into five main categories:

    a) Updates to the definition of a liability and the wording of the present obligation criterion.

    b) Changes to some requirements supporting the present obligation recognition criterion—specifically, changes to requirements affecting the timing of recognition of provisions for obligations (typically levies) that depend on two or more actions of the entity.

    c) Clarification of other requirements supporting the present obligation recognition criterion—for example, to distinguish more clearly the two criteria for a present obligation, and to provide more guidance on the meaning of 'can be enforced by law'.

    d) Improved explanations of the rationale for some requirements and for the conclusions in some illustrative examples.

    e) Absorption into IAS 37 of IFRIC Interpretations and IFRS Interpretations Committee agenda decisions.

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Updates to the definition of a liability and the wording of the present obligation criterion

22. The IASB staff suggest updating the definition of a liability in IAS 37 to align it with the new Conceptual Framework definition. They consider that eliminating the old definition from IAS 37 would streamline IFRS requirements.

23. Furthermore, the staff believe that updating the definition would not change any of the requirements in IAS 37, or how they are applied[1].

IAS 37	Conceptual Framework
A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

Changes to some requirements supporting the present obligation recognition criterion

24. The IASB staff suggest making changes to the requirements that they expect would change the timing of recognition of provisions in cases when obligations depend on more than one action of the entity. This could affect the timing of recognition of provisions for many levies, for example.

25. More specifically, the IASB staff believe that the following changes should be made to the requirements supporting the present obligation recognition criterion:

    a) Remove the existing requirement for obligations to exist independently of an entity's future actions in paragraph 19 of IAS 37, withdraw IFRIC 21 and replace them with the criteria for identifying a present obligation in paragraphs 4.32, 4.43 and 4.44 in the Conceptual Framework.

    b) Add four illustrative examples using the fact patterns of the examples accompanying IFRIC 21, amending the analyses and conclusions as necessary to align them with the Conceptual Framework.

    c) Add a fifth illustrative example for levies.

[1] For example, the 'probable outflows' recognition criterion in IAS 37 14 (b) means that unless a transfer is probable, no provision would be recognised

26. A link to the proposed illustrative examples is provided here (see in particular Illustrative Examples 13A – 13E).

27. Paragraph 19 of IAS 37 states that:

> "It is only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) that are recognised as provisions… In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised."

This has caused confusion because it doesn't define clearly when an entity has a present obligation because of a past event. In particular, it does not distinguish cases when an entity has no practical ability to avoid taking the relevant future action.

28. Paragraph 4.32 of the Conceptual Framework specifically addresses instances in which an entity's duty to transfer an economic resource is conditional on the entity's own future actions:

> "In some situations, an entity's duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business or operating in a particular market on a specified future date, or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action."

29. Paragraphs 4.43 and 4.44 of the Conceptual Framework include concepts that clarify when an entity has a present obligation as a result of a past event:

4.43 "A present obligation exists as a result of past events only if:

a) the entity has already obtained economic benefits or taken an action; and

b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer."

4.44 "If economic benefits are obtained, or an action is taken, over time, the resulting present obligation may accumulate over that time."

30. Importantly, these clarifications appear to mean that an entity can have an obligation when it has no practical ability to avoid taking the future action. This would therefore lead to a provision being recognised earlier.

Clarification of other requirements supporting the present obligation recognition criterion

31. The IASB staff consider that, by applying some concepts in the Conceptual Framework, several aspects of the requirements and guidance that give rise to questions in practice would be resolved. They highlighted the following areas:

    a) Untangling two elements within the present obligation recognition criterion.

    b) Clarifying the meaning of 'can be enforced by law'.

    c) Clarifying when commitments to reduce emissions to 'net zero' are present obligations.

32. The IASB Staff are of the opinion that clarifying these requirements could reduce diversity in practice, changing the way some entities apply them.

Untangling two criteria within the present obligation recognition criterion

33. The IASB Staff note that the Conceptual Framework does not refer to, or define, an 'obligating event'. Instead, it separately identifies the two criteria for a present obligation, emphasising that both criteria must be met and discussing each one separately. The staff consider that reorganising the IAS 37 requirements and guidance in the same way could clarify:

    a) the need to satisfy the two distinct criteria; and

    b) the difference between the two criteria and the way in which they are assessed—satisfying the 'past events' criterion depends on timing facts; satisfying the 'no realistic alternative to settling' (or 'no practical ability to avoid') criterion requires an enforceability assessment.

34. Additionally, the IASB Staff propose that the wording in IAS 37 is updated to match that used in the Conceptual Framework – changing 'no realistic alternative to settling' to 'no practical ability to avoid' – to streamline IFRS requirements.

Clarifying the meaning of 'can be enforced by law'

35. Paragraph 17 of IAS 37 explains when an entity has no realistic alternative to settling a legal or a constructive obligation.

36. There is, however, no further explanation of a legal obligation and, in particular, no guidance on how to apply this requirement to situations in which a counterparty cannot use the courts to force an entity to comply with legal requirements but can take other forms of action against entities that fail to comply. In some cases, the threat of that action might be sufficient to leave the entity with no practical ability to avoid complying.

37. In Agenda Decision Negative Low Emission Vehicle Credits, the IFRS Interpretations Committee concluded that it is not necessary for the counterparty to be able to use the legal system to compel the entity to settle its obligation. They decided it is sufficient that the counterparty has the legal right to take some form of action against an entity that fails to do so, and the consequences of that action are such that the entity is left with no realistic alternative to settling its obligation.

38. The IASB staff considers that additional guidance that is consistent with this conclusion, and that reflects some parts of the Conceptual Framework, would be helpful. This discussion, they believe, could cover the role of economic compulsion and obligations that could be avoided only by liquidating the entity (paragraphs 4.33 and 4.34 of the Conceptual Framework):

   4.33 "A conclusion that it is appropriate to prepare an entity's financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade."

   4.34 "The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer."

Clarifying when commitments to reduce emissions are present obligations

39. The IASB staff have suggested that IAS 37 is updated using paragraph 4.45 of the Conceptual Framework as a guide. This is because stakeholders have a challenge identifying when an entity should recognise obligations arising from an entity's own public commitment to change its operational methods in the future, for example to reduce its greenhouse gas emissions to 'net zero'.

40. Paragraph 4.45 of the Conceptual Framework states that "… an entity's customary practice, published policy or specific statement… gives rise to a present obligation only when, as a consequence of obtaining economic benefits, or taking an action, to which that practice, policy or statement applies, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer."

41. This explains that a legal requirement or public pledge to offset future greenhouse gas emissions does not in itself lead to a present obligation for an entity. An entity could have a present obligation for the costs of offsetting emissions only when it has emitted the gas it is required, or has promised, to offset. Until then, an entity only needs to provide information about its responsibilities to conform with other reporting requirements.

Improved explanations

42. Stakeholders have indicated to the IASB staff that the implications of some application requirements and illustrative examples in IAS 37 are misunderstood. In the staff's view, improved explanations could clarify the underlying principles—thereby making it easier to judge whether and how to apply the requirement or example by analogy to transactions not specifically addressed in IAS 37.

43. The staff have identified two types of transaction where improvements could be made:

    a) Restructuring provisions

    b) Obligations to exchange resources

Restructuring provisions

44. The IASB staff consider that the wording of the requirements in paragraphs 70 – 83 of IAS 37, which discuss restructuring provisions, causes misunderstanding. The wording suggests that the existence of a formal plan for a future activity combined with a public announcement of that plan is sufficient to create a present obligation for the costs of that activity.

45. Some people have applied the requirements for restructuring provisions to reach a view that entities should recognise the costs of achieving net zero emissions as soon as they have established and publicly announced a formal plan for doing so.

46. The IASB staff believe that this is not the correct interpretation of IAS 37, and that misunderstandings could be avoided if the requirements for recognising restructuring provisions were better explained. They emphasise that there is no need to change the requirements themselves.

47. There are three conditions which need to be met for a present obligation to be considered:

    a) Does a specified action of the entity give it a responsibility it has no practical ability to avoid?

    b) Does it have the potential to require the entity to transfer an economic resource?

    c) Has the entity taken the specified action?

48. The announcement of a formal plan, in the case of a net zero commitment, is not sufficient to create a present obligation. This is because although conditions a and b have been met, condition c has not been met.

49. This is different from the restructuring plan scenario where all the conditions have been met, including condition c; in such a scenario the employees have already provided the past service which gives them the right to compensation.

Obligations to exchange resources

50. The definition of liability in IAS 37 includes the need for there to be an outflow of economic resources. However, 'exchanging economic resources' and 'outflow of economic resources are not the same. The Illustrative Examples accompanying IAS 37 include three examples illustrating potential exchanges of economic resources:

    a) Example 6 - which discusses new legislation requiring entities to fit smoke filters in factories.

    b) Example 11A—which discusses a furnace lining that has to be replaced every five years for technical reasons. The existing lining has been in use for three years.

    c) Example 11B—which discusses a legal requirement to overhaul aircraft every three years.

51. The conclusion is that no provision is recognised because no obligation exists independently of the entity's future actions.[2] In examples 11A and 11B there has been a past event creating a possible requirement for future expenditure and, in all the examples, it can be assumed that the entity has no realistic alternative other than to incur that expenditure. The fact patterns (especially the fact pattern of example 11B) are similar to the fact pattern discussed in the IFRS Interpretation Committee's Agenda Decision *Negative Low Emission Vehicle Credits.* Several respondents to the Committee's tentative agenda decision questioned the tentative conclusion that a present obligation existed in that fact pattern—questioning how that conclusion could be reconciled to that in examples 6 and 11B.

52. The conclusion of the IASB staff was that even if obligations to fit smoke filters, replace furnace linings or overhaul aircraft arise from past events, they are not liabilities because they are not obligations to ***transfer*** an economic resource, they are obligations to ***exchange*** economic resources. These obligations therefore do not necessarily give rise to liabilities because operating within a constraint does not necessarily require an outflow of economic resources. This is because compliance does not require an outflow of economic resources but rather an exchange of one resource (cash) for another resource (equipment) and there is no net outflow. As outlined in Illustrative Example 11B accompanying IAS 37, a requirement to overhaul aircraft every three years is accounted for by attributing

[2] This conclusion is stated explicitly in examples 11A and 11B and that is also how Ex 6 has often been understood.

part of the cost of an aircraft to components that need to be overhauled every three years and depreciating that part of the cost over three years – not by recognising a provision for future overhaul costs.

53. Although the existing conclusion in Illustrative Example 6 is consistent with this analysis (no provision is recognised for the costs of fitting the smoke filters) the emphasis of the explanation is different. The existing explanation focuses on the fact that there is no 'obligating event', whereas the proposed new explanation distinguishes between exchanging and transferring economic resources. The potential trigger for a provision (obligating event) is the non-compliant operation of the factory: this is the activity that could trigger an outflow of economic resources in the form of fines and penalties.

54. The full analysis was presented in Agenda Paper 4 (Appendix A) Negative Low Emission Vehicle Credits (IAS 37)—Supplementary Analysis—reconciliation to IFRIC 6, IFRIC 21 and Illustrative Examples 6 and 11B for the June 2022 meeting of the IFRS Interpretations Committee.

Absorption of IFRIC Interpretations and IFRS Interpretations Committee agenda decisions

55. The IASB staff suggest that IFRIC 6 and IFRIC 21 are withdrawn and replaced with new illustrative examples to accompany IAS 37. In addition, the fact pattern and conclusions in Agenda Decision *Negative Low Emission Vehicle Credits* can be used as the basis for a further illustrative example.

Questions for the Board
1. What are the Board's overall reactions to the possible amendments? 2. Do Board members have any comments on any specific aspects of the possible amendments?

Specific questions to be asked by the IASB at ASAF in July 2023

56. Based on the papers issued in advance of the ASAF meeting, we expect ASAF members to be asked the following specific questions in addition to the general questions set out in the Questions for the Board above:

Thresholds

a) Should IAS 37 specify when an entity has a present obligation for costs payable if a measure of its activity exceeds a specified threshold?

b) Do you have views on when the present obligation arises?

Guidance on meaning of 'no practical ability to avoid'

a) Do you think IAS 37 should include guidance on the meaning of 'no practical ability to avoid'?

b) Should IAS 37 retain the requirement that settlement of a legal obligation 'can be enforced by law'?

c) What, if any, role should economic compulsion play in assessing an entity's practical ability to avoid an obligation?

Thresholds

57. This issue is linked to the suggested amendments described in paragraphs 24 to 30 above (changes to some requirements supporting the present obligation recognition criterion). As explained there, the IASB staff consider that including concepts from the Conceptual Framework will help clarify the relevant requirements.

58. The specific application question concerns when an entity has a present obligation for costs that become payable only if a measure of its activities exceeds a specified threshold. Examples include certain levies or penalties for exceeding specified emission levels, and thresholds could be based on cumulative or average measures.

59. One view is that the 'action' that creates the present obligation is activity above the threshold, and that no obligation exists until the threshold is exceeded. This view would lead to a provision being recognised later.

60. The alternative view is that the 'action' that creates the present obligation is the activity to which the charge applies (for example, generation of revenue or emissions). Under this view, an obligation starts to accumulate as soon as the entity starts to perform the activity: either because it has no practical ability to avoid exceeding the threshold or because the activity is viewed as one continuous

whole (i.e. exceeding the threshold is not a separate action). This view would lead to the earlier recognition of a provision.

Questions for the Board	
3.	Do Board members consider that IAS 37 should specify when an entity has a present obligation for costs payable if a measure of its activity exceeds a specified threshold?
4.	Do Board members have views on when the present obligation arises?

Guidance on meaning of 'no practical ability to avoid'

61. This issue is linked to the suggested amendments described in paragraphs 35 to 38 above (clarifying the meaning of 'can be enforced by law').

62. Paragraph 17(a) of IAS 37 states that an entity has no realistic alternative to settling a legal obligation only "where settlement of the obligation can be enforced by law". However, the IASB staff note that some recent (often climate-related) laws are not enforced through the courts but through the imposition of economic incentives to comply, or through government rights to impose sanctions. Views differ on whether in such cases the entities have obligations that can be 'enforced by law' and hence whether provisions should be recognised.

Questions for the Board	
5.	Do Board members consider that IAS 37 should include guidance on the meaning of 'no practical ability to avoid'?
6.	Should IAS 37 retain the requirement that settlement of a legal obligation 'can be enforced by law'?
7.	What, if any, role do Board members consider that economic compulsion should play in assessing an entity's practical ability to avoid an obligation?

Next Steps

63. Some of the matters covered in this board paper will be discussed at the AFIAG meeting on 15 June 2023. A brief verbal update of those discussions will be provided to the Board at its 22 June Board meeting.

64. The Secretariat will continue to monitor the IASB's discussions and will bring further updates to the Board as required.